Budgeting Theory | Accounting

General Budgeting Questions:

Why are budgets prepared and what makes a good budget?

- Budgets are prepared to help management in controlling the business.
- They act as a target upon which actual performance can be measured.
- Effective budgets give advance warning of problems which may arise (e.g. cash flow shortage).
- They act as a powerful motivator for staff.

What are the advantages of budgeting?

- Ensures correct planning takes place.
- Draws up a plan of expected performance.
- Defines areas of responsibility.
- Acts as a motivator for staff to achieve targets.
- Improves communication between staff.
- Ensures resources are used as efficiently as possible.
- Enables comparisons between actual figures and budgeted figures (variance analysis).

What is the purpose of management accounting?

- Decision making.
- Controlling the business.
- Future planning.
- Motivating staff.
- Communication of up to date info.
- Allows for variance analysis.

Budgeting – Cash:

Factors to consider when estimating future sales figures (2016):

- Market research and trends/opinions of sales representatives may be a reliable indicator of potential sales.
- Price to be charged for product/service.
- Intensity of competition in the market place.
- Expected growth of economy in coming months.

Define "cash budget", and describe two of its advantages (2007):

- A cash budget is a forecast or a plan of cash inflows and cash outflows over a period of time;

Advantages:

- Highlights weather sufficient cash will be available to meet future needs.
- Helps to give advance knowledge so that overdraft can be arranged if shortfall/shortage of cash occurs.
- Helps to predict future surpluses so that short term investments can be made.

Explain what is meant by "Master budget". List the components of a master budget for a manufacturing firm:

- A master budget is a summary of all the other budgets and provides an overview of the operations of the company for the planned period.

Components:

- Budgeted manufacturing account.
- Budgeted trading, profit & loss a/c.
- Budgeted balance sheet.

Accounts analysis (2006):

- **Variance analysis**: Is where management analyse why actual figures differ from budgeted figures.
- **Favourable analysis**: Is when the results differ in a way that the firm will be more profitable than expected.

- **<u>Adverse analysis</u>**: Is when the results differ in a way that means the firm will be less profitable than expected.

**Budgetary control is another way of saying Variance analysis".*

Why might adverse variance arise in 1. Materials and 2. Direct labour costs?

- **<u>Materials:</u>** Prices paid and/or quantities used were greater than expected.
- **<u>Direct labour costs</u>**: Price variance where actual direct labour cost per hour is greater than budgeted. // Usage variance where the actual number of direct labour hours used in production is greater than budgeted.

What are the objectives of a cash budget? (2007):

- To ensure that there's always sufficient cash available to meet the financial demands of the operating business on a daily basis.
- To anticipate periods of cash surpluses and therefore arrange short-term investments to earn maximum interest.
- To anticipate periods of cash shortages so that management can arrange alternative sources of finance or even a bank overdraft to cover the deficit.

Budgeting - Production:

Why is it important that a business prepares regular budgets (2017):

- Budgeting is part of the financial planning process (a financial road map for a business).
- Helps define areas of responsibility for staff and also motivates staff (teamwork etc.…)
- To ensure resources are used efficiently and can adapt quickly to changing circumstances.
- To compare budgeted figures with actual performances (Variance analysis).

State and explain 2/3 reasons for product costing (2019):

- Establishes the selling price for tendering purposes.
- Controls cost by comparing budgeted with actual costs.
- Helps with planning and decision making.
- Finds the value of closing stock in order to prepare final accounts.

Explain "Principal budget factor", (2008):

- This is the factor that restricts an endless production of a certain product. i.e. This would often be due to sales demand or availability of raw materials, availability of labour, plant capacity or availability of capital.

Explain "Capital budget", (2008):

- This budget deals with planned expenditure of a long-term nature. i.e. Capital expenditure such as purchase of fixed assets and planned capital receipts (e.g. Sale of Fixed assets).

Budgeting - Flexible:

Distinguish between the terms “contribution”, and “profit”. (2018):

- Contribution is sales revenue less variable costs. This goes towards paying off the fixed costs. Once the fixed costs are paid off, any further contribution goes towards profit. Profit is sales revenue less total costs (fixed and variable).

Explain with examples “direct”, and “indirect”, costs. (2014 Examcraft mock):

- Direct costs are costs that can be traced/directly linked with a given cost object (i.e. direct wages or materials).
- Indirect costs are costs that cannot be traced directly to a given cost object (i.e. Supervisors salary // insurance).

What is the purpose of flexible budgeting? (2003):

- To compare budgeted costs with actual costs at the level of activity.
- To compare like with like.
- To control costs and plan production levels.